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Managing Risk in a Post-Crisis World: The Role of Internal Audit

Good afternoon, everyone. I'm very pleased to be here today. This is my first opportunity to speak to an industry group of internal auditors, so I'm not sure what to expect. I imagine you take better notes than most, and will point out any errors in my speech. No formal reports are necessary, however.

I'm sure Jim Spangler or Rob Peiffer could speak for hours about their challenges at DTCC and how they're meeting them. (In fact, I've already heard them do that!) But as I think more about it, I hope you'll see value in hearing about their progress from a non-auditor's perspective. What I want to talk about today is how Internal Audit's transformation at DTCC is not only part of a comprehensive change in how we face risk within our organization, but is also a critical driver of that change.

I'm pleased to talk about this because we anticipate the changes we're undertaking at DTCC will give us the ability to deliver, quite simply, a much higher level of certainty, stability and reliability for the financial markets and our customers.

I have to assume that most, if not all, of you know the role DTCC plays in the industry, but let me remind you of a few salient facts. As you know, DTCC is the largest post-trade financial services organization in the world. Through our subsidiaries, we provide clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. We're also a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks. Our depository provides custody and asset servicing for more than 3.6 million securities issues from the United States and 121 other countries. As you can imagine, the value of the transactions we handle is immense. In 2010, for example, we settled securities transactions valued at more than one and a half quadrillion dollars.

Introduction

Given that scope and the sheer volume of transactions we handle, DTCC was, of course, deeply involved in addressing the financial crisis of 2007-08, and has focused extensively on examining the "lessons learned" from that experience. One outcome of the crisis is that financial services companies are discovering – or in some cases, re-discovering – what a powerful tool their internal auditors can be for mitigating risk. And risk mitigation, of course, is the Holy Grail of the industry right now. Although many of us in our industry think that we did a pretty good job of controlling the financial fires that broke out in 2008, that's hardly the view of the public...or of elected and regulatory officials...or of investors, here and overseas. They're still angry that the financial world unraveled so badly in the first place – bringing on the worst recession in three-quarters of a century – and they are adamant that we have better risk controls in place, both external and internal.

As a result, Congress passed the most comprehensive revision of our financial services laws since the 1930s, and regulatory agencies are now translating this into new rules. Policy makers in Europe are moving in the same direction. Meanwhile, regulatory oversight has already become more intense, and board committees

with responsibility for risk, compliance and audit functions are turning on some very bright searchlights. They want to see clearly what their companies are doing to identify and mitigate risk issues, and they want to see how internal auditors can help them.

Without going into the back story, let me confess that I was once quoted by a European newspaper as suggesting that clearing and settlement had become “almost sexy”. Well, I think we now have a new candidate for that description. With all the attention that’s now focused on it, internal audit has become today’s “almost sexy” activity. Congratulations...I guess.

In fact, there’s considerable expectation across financial services that you as auditors can and should play a far broader role in risk analysis and control than you have traditionally. As many of you know, however, because you’re grappling with them, these new demands can be challenging. You’re now being asked to focus on far more than financial and operational risk. You’re being asked to analyze systemic, enterprise, human capital and reputational risks...all risk factors that may not have ever been part of your job description in the past.

This new role for internal audit is what I will explore with you today, and I want to do it in the context of the more rigorous regulatory environment we now operate in. In particular, I want to discuss the realization all across our industry that, by expanding the scope and practices of internal auditors, we can be more aggressive and more imaginative in how we go about improving risk management. To give examples, I will talk about how we’re approaching this challenge at DTCC, and especially how we’re harnessing internal audit to help us strengthen and deepen our whole approach to risk control.

The new regulatory environment

On the legislative and regulatory front, as you know, much of the focus right now is on digesting the massive Dodd-Frank bill, which runs to more than 2,300 pages. Compare that to the Sarbanes-Oxley Act, which Congress passed in 2002. It was only 66 pages long, and as many of you will recall, it created a lot of work for internal auditors. Given the length of Dodd-Frank, I suspect your skills will remain in demand for quite a while.

Several sections of Dodd-Frank will have a particular impact on us at DTCC. We had anticipated that would be the case and, not surprisingly, over the past 18 months we’ve dedicated a great deal of time to establishing relationships with lawmakers and regulators in Washington to help shape the legislation. Today, we’re actively engaged in the rulemaking process, meeting with the agencies and authoring comment letters to ensure that our input, based on more than four decades of experience, is taken into consideration as the new regulatory landscape is crafted.

One principal provision of the legislation that will impact DTCC deals with market stability and systemic risk. As the world’s largest market infrastructure organization, we have responsibility for key components of the U.S. market structure, and consequently we face systemic risk concerns. We have spent much of the last two years cataloging practices and processes where we might be vulnerable to or could create systemic risk exposure. We’ve also spent a lot of time talking to our customers, our staff, our colleagues in other infrastructure companies – as well as various regulators – in order to come up with alternative solutions that would help us mitigate this kind of exposure. I’ll explore this some more later, but my point is that we’re now institutionalizing this process, and the recipe includes a big role for Internal Audit.

Another section of the Dodd-Frank bill that will particularly affect DTCC involves the push for greater transparency and disclosure. In order to gather and analyze more information on financial transactions, the bill creates a new Office of Financial Research within the Treasury Department. DTCC, of course, houses a great deal of trading information and other data that we expect will be just what the new office is looking for. Since

we collect the data, we think it will be significantly cheaper for the industry to have us supply it than for individual companies to have to collect and submit their own data. We're already responding to a request from the new office for an international identifier system for institutions, and we're looking across all our data banks to see which data might be most useful for analyzing systemic flows and risks.

Meanwhile, even before all the new financial rules get written, regulatory officials have made clear that they expect us to be far more vigilant about risk mitigation. In fact, we now have more than eight separate regulatory personnel who work full time on our premises, and that number continues to grow. Our regulators, both here in the States and in Europe, are demanding much more robust risk management from infrastructure organizations like DTCC precisely because our operations may create systemic risk.

DTCC Response

In response, we launched a top-to-bottom transformation last year at DTCC in how we think about risk, how we oversee risk, how we manage risk and how we intend to mitigate risk – and this includes risk both within DTCC itself and more broadly across the financial system in which we operate. As you can appreciate, this is a huge challenge. It is not, however, a totally abrupt change of course. We have been taking a series of steps toward this transformation for several years.

Let me note that we're very proud of our extremely strong record of handling industry risk problems for more than 40 years. We have done our job very well. But times have changed. In today's global financial services industry, we need to write a new job description. We need to rethink and re-imagine everything we do in our business from a risk-mitigation point of view, including how we acquire and use technology. We need to ask this question: what are we really doing to address foundational and fundamental systemic risk issues for the industry?

To answer that question, we first need to create management structures – or empower our existing structures – with responsibility to focus on those issues. For instance, our audit, compliance and operational risk oversight groups each bring overlapping perspectives to assessing DTCC's control structures. We're working on integrating these perspectives and extending them even further – into our information technology risk management functions.

The other step we need to take is to give our employees freedom to try new things, permission to question our standard operating procedures, opportunity to establish new standards, authorization to deploy new technologies and acquire new skills, and encouragement to see old things in a new light. Some people like this, of course. Others find it difficult or uncomfortable, because it is definitely not business as usual.

Within the company, the shorthand description we use to capture this change is DTCC 3.0. We're also using the traditional "three lines of defense" model to structure our effort. The first line belongs to our individual business units. They have to own the risks related to their business. The second line rests with our specific risk control areas such as compliance, market risk management, and operational risk management.

I should add that we've also expanded our definition of specific risks. Two years ago, for example, we set up an office of Systemic Risk in recognition of our role in the industry and in anticipation that regulators will designate DTCC as an institution of "systemic importance". Now we have a nearly 50-page study that catalogues various systemic risks we face. And more recently, as part of several steps to give our whole new approach to risk management the level of corporate attention and focus we think it requires, we created a new position for a Group Chief Risk Officer.

The Third Line

The third line of defense, as you all know because this is your job, is our internal audit function. But this is not business as usual either. Instead, our internal auditors are becoming our shock troops. Their assignment, and it's a difficult one, is to help drive change in how we identify, assess and measure risk.

We may think our biggest risks lie in operational or financial areas, and traditional audit practices tend to focus on them. However, a recent study by the Corporate Executive Board found that the main force driving down shareholder value in public companies involves strategy and business decision making, not operational risk problems. According to the CEB, operational risk events were the root cause of just 15 percent of major declines in shareholder value. Strategic and business risk events could be blamed for 68 percent of such declines. And so we're asking our internal auditors to make those risk exposures a greater component of the audit process...and to share their findings with our compliance and operational risk areas.

This is the new background – the new understanding – within which Internal Audit has to work. Our auditors today are compelled to ask new and different questions. While our managers tend to have a good understanding of the many risks we face, Internal Audit is helping us to connect the dots so that we can see where the most significant exposures exist. This represents an entirely new responsibility for our internal auditors, but their contributions in this area will have a significant impact in protecting our company and, by extension, the industry itself. So they're rewriting their job description too.

We began this journey about two years ago, in the midst of the Lehman bankruptcy, with the hire of Robert Peiffer to be our new General Auditor, and Jim Spangler joined us three months later. Rob and Jim worked with the existing team to create a new mission and vision for Internal Audit. And they didn't hesitate to borrow best practices from our owners and the industry, companies like Morgan Stanley, Citibank and Bank of America. They have also designed a number of new processes that we believe are unmatched in the industry. As a result, we can now see a five-point approach evolving at DTCC.

Point 1: Instilling a top-down approach

The first point is to ensure that the top risks facing the company are what drive the annual audit plan and resource allocation. Typically, internal audit functions plan their work using a "bottoms-up" approach, involving granular risk assessments of the audit "universe" to drive the frequency and scheduling of audits. For 2011, however, Internal Audit turned its traditional planning process on its head. The team started by identifying the top risk scenarios facing DTCC.

To do this, they used existing sources of information such as corporate goals, our pipeline of key initiatives, international standards for clearing companies, and key risk scenarios monitored by our operational risk and systemic risk teams. Then they spent a significant amount of time brainstorming to come up with a list of roughly 35 scenarios that, if realized, would cause significant harm to the company or the markets as a whole. Once that exercise was complete, they designed their 2011 audit plan to help ensure robust coverage of those specific scenarios.

This new approach has led to a very different audit plan -- one that uses more targeted reviews to address specific risks facing the company. The old universe risk assessments are still used, but as a secondary rather than primary driver of the audit plan. The Audit Committee and our regulators have embraced the new approach, as it more clearly identifies the key risks facing the company and maps how the audit plan provides assurance around the management of those key risks. It's an auditor's version of "Let's get real!"

Point 2 – Promoting management awareness for identifying and reporting risk

Just as importantly, we're instituting several new tools that promote management awareness and accountability for risk management and internal control, with a particular focus on identification, reporting, and education.

Let me start with Identification. In a lot of major institutions, there's a clear understanding that, if you as a manager find problems or potential issues in your area, you're expected to talk about them and begin discussing how they can be addressed – even when you aren't being audited. You don't need an audit or a regulatory examination to begin assessing potential problems or to take accountability for solving them. At best, these are only annual processes, and you might need to act sooner. You might see problems crop up during your planning process. You might see risks identified during the new business screening process. You might be hearing things from your customers. In a risk-focused environment, all of that is valuable information. It helps us stay ahead of the game.

At DTCC, Internal Audit is helping to jump-start our push for greater self-identification of control issues by using a device several companies now use – a “management representation letter”. The letter asks the senior officer in the unit they're preparing to audit to assess the quality of the control environment and to disclose any shortfalls, both those where the area is working on a remediation plan and those where the area has decided to accept the risk involved. The letter also asks questions about customer complaints, system outages and recent operational losses; questions about fraud risks, key person risk, and whether policies and procedures are up-to-date. It asks whether the area has a good understanding of the key laws and regulations governing its activities. And it asks the unit for information on how it is proposing to deal with any shortfalls that have been identified.

This management letter serves three important objectives:

- First is Education – The questions we ask are meant to be thought-provoking. Some managers may not have thought about all these points. Now they can see they have a roadmap for understanding the key risks that may face them.
- The second objective is Efficiency. The business unit itself is providing information that can expedite the audit process.
- Accountability is the third objective. The unit – not the auditors – becomes responsible for understanding the key aspects of its control environment, and for disclosing all known issues. In essence, if this is your business, then you ought to be thinking about these things.

Externally, the information we receive in response to the management letter can also be quite useful. We can use it both to illustrate to our regulators and our customers what kind of controls we have in place, and to get feedback from them on how effective the controls look from their point of view. Since implementing this new approach, we've already received positive feedback from certain regulators, and other risk and control groups are eager to leverage the information collected.

We have, by the way, also considered – on several occasions – whether to conduct a full SAS 70 review of our key activities. Many of your organizations utilize SAS 70 in parts of your business, particularly for asset management and custodian services. While we recognize the benefits of a SAS 70, we historically have chosen not to undertake one. A major reason is cost – does it really make sense for us to be spending your money that way, particularly, today, given that the current process will be replaced by a new international standard in about six months? To respond to this issue, we have long provided our members with an internal control attestation letter, and we are exploring a number of ways to provide our members with more information on our key risk management processes...information that will bring greater transparency and, hopefully, greater confidence in DTCC for our members, without much of the cost and complexity that a SAS 70 may introduce. This debate isn't over, however, and as we move forward with our initiatives, I would be curious to know what

advice you may have for DTCC on this question.

As I mentioned, in order to drive home the importance of risk and control consciousness, we're also changing our approach to audit reporting to include formally evaluating our officers on their control awareness and their responsiveness. As a result, our officers will now get two report ratings: one for the control environment, and one for their understanding of that environment.

As managers learn to identify and report potential risks over the course of the year, they will be in a better position to list these matters as we prepare for an audit. In other words, both the auditee and the auditor are already thinking about these matters before an audit gets under way. And the more this cycle of risk recognition and mitigation takes place, the deeper we can drive a true risk-consciousness into our organization.

Point 3: An Organization of Risk Mitigators

Part of our challenge in this new risk environment is to find ways to extend the mission of internal audit beyond the internal audit department – and not just at the upper management level. We need the hearts and minds of everyone. As good a job as you do, the reality is that internal audit can't be everywhere at all times. And yet the reality is that, no matter how hard you scrub, there continues to lurk in every corner of an organization, and in virtually every task we perform, potential systemic, financial, operational and regulatory risks.

Trying to spot those risks is a bit like trying to find a needle in a haystack. The likelihood of success is pretty small. But what if you ask the hay to tell you where the needle is? Now you've increased your odds significantly.

This same concept applies to identifying and mitigating risks in an organization like DTCC. Internal auditors are trained to find the hotspots – and at DTCC they're now pushing managers to look for them as well. But that's still a little like looking for that needle in the haystack. So we're now spearheading an education program at DTCC starting this year to train employees to help find the proverbial needle. With the help of Human Resources, Internal Audit is developing training in the fundamentals of risk and controls that will be mandatory for all employees. We're close to rolling out new training to up-and-coming middle managers in help them learn how to build out their area's risk profile.

By empowering all employees to act as part-time risk managers, we expect to be more effective at identifying the types of risks that may have been tolerated or overlooked in the past or, possibly, not even viewed as a potential vulnerability. The men and women on the frontlines of an organization have a unique perspective on the functions they perform. While they can probably point out weaknesses to us, no one ever asked them to make that kind of assessment before. When they look at their responsibilities through the lens of risk mitigation, I have no doubt that they'll offer all sorts of valuable contributions on ways to enhance controls.

I liken this approach to the local neighborhood watch that we see in many communities across the country, where a group of concerned residents take on the responsibility of serving as the eyes and ears of law enforcement. Their mission is not to carry handcuffs and guns or to throw themselves into the middle of a criminal act to arrest a perpetrator.

Rather, the neighborhood watch is there to keep an eye on what's going on around them, to question what looks out of the ordinary, and to speak up if they believe something is wrong. If you take the trains or buses here in New York, you've certainly seen the posters by the Metropolitan Transit Authority encouraging riders: "If You See Something, Say Something." Well, that same rule can also apply to risk within an organization. Think of it as issuing an all-points bulletin on risk.

Point 4: Bringing new perspectives to Internal Audit

Next, we are expanding our own talent base to bring new skills and fresh perspectives to the internal audit function. We've made several important hires from the industry in the last 12 months, and several outstanding performers from other departments are now joining Internal Audit, including high potential individuals from Operations, Technology and even Relationship Management. These individuals may have no past experience in Internal Audit, but bring very different skills, experience, and behaviors to the existing team. Their unique backgrounds will bring new ideas and unique vantage points to the team's work. They are attracted by the new vision for internal audit, particularly the ability to influence how the company identifies and manages strategic and systemic risks.

Also, the focus in each of these internal and external new hires is identifying people with strong intuitive thinking skills – people who can think out of the box, generate new ideas, and who have the courage to speak up, even if their views may be unconventional or unpopular. These behaviors have growing value in the new DTCC.

Point 5: Outreach to Regulators

As I mentioned earlier, DTCC is already a highly regulated company and, under Dodd-Frank, we fully expect to be named a “systemically important” market utility by the new Financial Stability Oversight Council, which will mean that we will face even stricter regulatory requirements in the years ahead. We also know that all financial firms will be under more intense regulatory scrutiny. I raise this issue because I believe that internal audit can play an important role in helping companies meet their new responsibilities to regulators in a more efficient manner.

Regulators and internal audit share the same goal – to ensure a vibrant and competitive industry by protecting the safety and stability of markets themselves as well as market participants. In many cases, regulators look to internal audit to serve as an internal line of defense that is self-identifying and addressing potential risks in a timely manner. A robust internal audit function gives regulators an added degree of confidence that a company takes seriously its responsibility to enact and comply with adequate controls and protocols.

In fact, as we see it, the key is to open a dialogue with regulators and to remain engaged in that conversation – in essence, to recast the hands-off or even adversarial relationship many firms currently have with regulators... and to pursue a policy of engagement. We have initiated a kind of literal “open-door” policy at DTCC now. Senior management doors, as well as our Internal Audit Department doors, are always open to our on-site regulators. If they have questions or concerns, we want to hear about them and discuss them.

Conclusion

These are just a few key examples of how we are transforming the internal audit function at DTCC, and how that transformation in turn is a critical part of a top-to-bottom make-over of our whole approach to risk mitigation throughout our entire organization. I don't think anyone here will disagree that more conventional approaches appear to have failed the industry. They simply haven't worked, and there are millions of people without jobs and with severely eroded savings as a result. New challenges require bold new ideas. I hope that you all will consider turning some of your legacy processes upside down and inside out, and I hope that you will share your successes widely. We all have a responsibility to protect global financial markets. That has always been DTCC's mission, and that must be the internal audit profession's mission too.

Thank you.